Lessons Learned from Ponzi Schemes

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Errors are mine.
Overview

- Schemes and Scams
- Ponzi Schemes
- Chinese Warren Buffet
- Bernie Madoff
- Chinese Ponzi Schemes
  - P2P Lending
  - Anbang Insurance
- Lessons Learned
Schemes and Scams

- Long history of financial fraud
- Widespread occurrence today
- Designs to fool investors & steal their money
- Prey on gullibility, greed and other motives
- Pyramid schemes versus Ponzi schemes
  - Pyramid schemes more transparent
  - Pyramid schemes may have a real product
  - Investors incentivized to recruit more people
  - Legitimate multi-level marketing
Ponzi Scheme

- Promoter promises attractive returns
- No actual investment
- Sets up fake accounts
- Money from new investors pay for exiting investors
- Need an increasing flow of new money to sustain scheme
- Typically the scam is discovered
- Promoter disappears or gets caught
- Average investor loses
The Chinese Warren Buffet

- Weizhen Tang from Toronto
- Promised one per cent per week.
- Claimed to invest only 1% of the funds!
- Appeal to Chinese community
- *Chinese work too hard, and they work too much—yet they have very, very little to show for it*
- Organized seminars and charity events in Toronto.
- Scheme collapsed in 2009 with losses of $60 Million
Bernie Madoff

- Bernie Madoff Investment Securities
- Traded stocks as broker in early 60’s.
- Provided a third market
- Competed with specialists on NYSE
- One of the first to automate trading through computers
- Firm became a very important broker dealer
- This was a **profitable and legitimate business**
Gained Respect in the Industry

- Madoff was active in industry and professional circles
  - Served on NASD committees
  - Member of the NASD board
  - Chairman of NASDAQ
- Gave to charity
- Had good relations with the SEC
- Firm anticipated (& influenced) regulatory changes
Investment Adviser

- From inception Madoff acted as an investment adviser
- Conducted this business in secret
- Early investors included his father-in-law Saul Alpern and Alpern’s clients.
- Madoff provided very good returns
- Not clear when or why he started Ponzi Scheme
- Conjecture: He had a bad year
- Faked returns with intention of paying back
- Dug deeper in the hole
Madoff Early Investors

- Early investors were family and friends
- Madoff targeted Jewish groups
- Affinity fraud: feature of several Ponzi schemes
- Promised and delivered high returns
- Was able to backdate trades
- Fake buy low sell high.
- Had ability to generate big losses
Split Strike Strategy

- Go long selected blue chip stocks in S&P 100
- Sell out-of-the-money call options on the Index
- Buy out-of-the-money puts on the Index
- Strategy limits losses because of puts
- Call option sales help defray the cost
- Strategy truncates both tails
- Madoff claimed to go into cash for certain periods
- Claimed stock picking and market timing ability
Feeder Funds

- Starting in 1990 used feeder funds
- Very productive marketing channel
- Returns of around one percent per month after all fees
- Funds received fees (say one percent plus 20% performance fee)
- Madoff only collected commissions
- Example: Fairfield Greenwich Group: Fairfield Sentry
Why He Could Raise Money

Several reasons why Madoff was able to raise money:

- He looked the part
- Good steady returns
- High profile in industry
- Reputation for charitable giving and on boards
- Waiting list made it exclusive
- Played to ego and exclusivity
- Broker dealer operation added credence
- Very profitable investment for the feeder funds
Flayed by the Financial Crisis

- Asset prices plunged
- Stock market dropped by 40%
- Correlations and volatilities increased
- Massive redemptions because of panic
- Often Madoff’s fund was the last one to be redeemed
- Fund could not meet the flood of redemptions.
- He confessed on December 11 2008
- Convicted and sent to prison for 150 years
Chinese Scams

- Ponzi schemes widespread in China

Some possible reasons:
- Low interest rates from banks
- Disillusion with stock market
- Lack of financial knowledge on risk return
- Regulations inadequate or outdated
- Income inequality
- Guan Xi culture
- Reporting in media
- Officials turning a blind eye to schemes?
Chinese P2P platforms

- Rapid growth of P2P platforms in China
- Popular since access to credit is still difficult
- 6,000 launched in last few years
- Only 2,000 survived to Feb 2018
- Decline due to fraud, competition and regulation
- New regulations introduced this year
- Licensed at the city state level
- Limits on loans: no principal guarantees
Chinese P2P Ponzi Scheme

- Some of the P2P platforms are Ponzi schemes
- Offer very high interest rates
- Investors promised bond like returns
- Funds claimed to be invested in actual projects
- Ezubao: Launched in 2014
  - 95% of its projects were fake
  - Interest rates 9-14.6%
  - Collapsed in Feb 2016
  - 900,000 investors lost money
Ezubao

- Ding brothers got life sentences
- Lavish spending on gifts and salaries
- Spent 1.5 billion RMB in Ezubao funds on himself
- Secretaries to dress only in Chanel, Gucci and so on to appear highly successful
- Annual meeting in Beijing’s Great Hall of the People
- Executives advertised on CCTV, the state owned official TV
Anbang Insurance

- Founded by Wu Xiaohui, a well-connected person
- Wu bought Waldorf Astoria in NYC for $2 billion USD
- Sold investment linked non-life products
  - Return of premiums with generous interest
- Anbang sold these products to 10.5 million investors
  - Exceeded approved quota by 723 billion RMB
  - 160 billion RMB siphoned off to other companies
- Portion of funds injected back to increase capital
- Falsified accounts to fake solvency numbers
Anbang Insurance Contract

- Investor pays single premium P
- Accumulation rate: deposit rate plus 60 basis points
- Maturity n years
- Return of P(1+n*i) at maturity
- Plus insurance coverage up to 2P per annum
- Either fire or earthquake or aviation
- Needed good investment returns to cover this
- Very poor asset liability matching
Mr S. Wang from Beijing

- Buys Anbang Winner No 2 in July 2012
- Single premium 100,000
- Benchmark 5 year rate at People’s Bank of China
- Credited rate is $4.75\% + 0.6\% = 5.35\%$
- Maturity payment = $126,750$
- Insurance cover 200,000 per annum
- Accident in year one. Suppose claim is 180,000
- Accident in year four. Suppose claim is 175,000.
Anbang Insurance

- Anbang could only survive by issuing more contracts
- High returns only sustained by new investors
- Hence it was a Ponzi scheme
- Wu was detained on June 8, 2017
- In February 2018, China's insurance regulator took control of Anbang
- On May 10, 2018, Wu was sentenced to 18 years in prison
Anbang: Why Did It Occur

- CIRC failed to uncover errors in reports
- Some accounts were forged
- Wu was well-connected with CIRC head Xiang Junbo
  - Xiang was convicted of serious violations of political discipline and rules.
- Banks formed credible sales channel
- Failure of regulation?
Due diligence

- Is the story plausible?
- Check out the company
- Qualifications and experience of principals
- Are the service providers credible?
- Verify that assets/ investments are real
- Are accounts, returns audited?
- Who computes returns?
- Are returns reasonable?
- Are the regulations followed?
References

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- Diana B. Henriques (2011), "The Wizard of Lies: Bernie Madoff and the Death of Trust“.